No. 12079

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

WILSHIRE & WESTERN SANDWICHES, INC., a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF OF PETITIONER.

Petition to Review a Decision of the Tax Court of the United States

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TABLE OF AUTHORITIES CITED

Cases

Statutes

Codes Cited in Appendix

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In his brief, respondent twice (Resp. Br. p. 22) accuses counsel for petitioner of distorting the lower court's findings by considering findings out of context. Petitioner considers this a serious matter for it is tantamount to an accusation that counsel for petitioner are attempting to deceive this Court by misstating the record. For that reason petitioner adverts to the two specific instances given by respondent (Resp. Br. p. 22) of the so-called consideration of specific findings out of context.

One of the specific findings purportedly considered out of context was the finding that "the original intention was to make advances totalling Thirty Thousand Dollars ($30,000.00) for stock and loans on an equal basis," which was treated in petitioner's brief at page 15. The other specific finding purportedly considered (Resp. Br. p.

16) out of context was the finding that "at the time the advances prior to November were made, the individuals intended that stock would be issued for one-half thereof and notes for the remainder." These findings were discussed by petitioner (Pet. Br. p. 15, *et seq.*) to support its contention that the Tax Court's Conclusion of Law was not supported by its Findings of Fact.

An examination of the formal Findings of Fact with particular reference to the facts above quoted reveal that the Tax Court chose to make its formal Findings of Fact in narrative form. After reciting the historical background of the petitioner [R. p. 27] it proceeded chronologically to a point in April, 1941 [R. p. 28] the time of the first discussion by petitioner's incorporators of "the question of financing the construction of the restaurant out of advances by them to Petitioner for the purchase of its stock and as loans." [R. p. 28.] Immediately thereafter the Court recited the quoted finding concerning the original intention. Immediately following that finding the Court proceeded to elaborate upon what it felt to be the desires of the individual incorporators, by pointing out that these individuals wished to participate in part with general creditors if the business were not successful, that they regarded a loan to be a better investment than stock for the purpose of obtaining returns and repayment of capital, that they discussed the question of borrowing from the bank and decided that they preferred to receive the interest individually, that they discussed the tax benefits, that Simon and Lyman considered their "contemplated *loan* to be safe" that the same individuals had entered into similar transactions for the same reasons with respect to other corporations and with the exception of two occasions, "the *notes* received for *loans* were in proportion to the stock received." (Italics ours.) [R. pp. 28-

29.] In the next paragraph the Court proceeds to talk about the negotiation by Simon for a lease for the premises, a subject which it is submitted, there is no reason to treat in discussing the original intention of the parties.

After discussing the foregoing lease negotiations and still proceeding in narrative chronological order, the Court next makes findings concerning the estimates of costs of improvements [R. p. 29], and the fact that in June bids were solicited and in July a contract was made for the construction of the building. [R. p. 30.] The Tax Court then made findings [R. p. 30] concerning the payments by the incorporators to petitioner and after pointing out that the payments made in November were agreed upon in November, the Court stated as a portion of its formal Findings of Fact that "at the time the advances prior to November were made, the individuals intended that stock would be issued for one-half thereof and notes for the remainder. No receipts were given by petitioner for the advances." [R. p. 30.] Immediately thereafter in its narrative findings, the Court states the use to which this money was put. [R. pp. 30 and 31.]

Apparently respondent expects that all of the formal findings of the Tax Court must be recited on each and every occasion petitioner desires to point out to this Court that the trial court found a particular fact to be true. Petitioner, on the other hand, does not see how its failure to touch on Simon's negotiations for a lease in connection with its reference to and reliance upon the finding concerning the original intention of the parties can possibly place upon the quoted sentence a meaning different from that which the sentence itself evidences. Nor does petitioner see how its failure to mention the fact that monies were used for the costs of preparing plans and specifica-

tions and for the building and for building costs, and so forth can possibly alter the meaning of the Tax Court's language that "at the time the advances prior to November were made the individuals intended that stock would be issued for one-half thereof and notes for the remainder."

In discussing these formal Findings of Fact, to which he diffidently refers as "reciting the facts" (Resp. Br. p. 22) respondent avers that "the Tax Court stated what is conceded by all, namely, that the incorporators intended to take half their investment in the *form* of notes and half in the *form* of stock" (italics ours). The truth of the matter is that nowhere in the entire formal Findings of Fact does the Tax Court use the word "form," or the phrase "form of notes" or "form of stock." If, in its formal Findings of Fact, the Tax Court meant to find that the original intention was not to make advances totalling $30,000.00 for stock and loans on an equal basis, but was to contribute $30,000.00 to capital while pretending to loan one-half thereof, the Court did so in a manner both curious and ambiguous. Petitioner is not prepared to join respondent in reading into the formal Findings of Fact words which the Tax Court did not itself see fit to furnish.

Apart from respondent's attack upon petitioner's treatment of the record, respondent's position, as revealed by his brief, is elusive and difficult to pin down. It is a curious thing that although respondent's claim against the petitioner for additional income taxes has progressed through the administrative stages of respondent's office, through a trial in the Tax Court and after that trial and the Findings of Fact and Opinion and Judgment to a stage in the appeal beyond the filing of respondent's

brief, petitioner still remains uninformed as to the precise reason for respondent's refusal to treat a portion of the advances to petitioner by its incorporators as an indebtedness. This refusal might stem from either of two contentions of respondent: First, that the notes received by said incorporators were mere pieces of paper, never intended to have legal effect, or second, that although petitioner was genuinely obligated to the individuals over and above the obligation of a corporation to the owners of its stock, such genuine non-stock obligation is so hedged with attributes of a corporation-stockholder relationship that it may not be treated as an indebtedness within the meaning of Section 23(b) of the Internal Revenue Code. Either of the foregoing alternatives might be covered by the general statement used both by the Tax Court [R. p. 40] and respondent (Resp. Br. p. 16) that in tax matters the concern is with substance and reality and not with form. And either might be covered by the statement, also used by the Tax Court [R. p. 39] and by the respondent (Resp. Br. p. 20) that a bona fide creditor relationship did not exist.

In his argument, respondent confuses a discussion of sham transactions with a discussion of the hybrid obligation types of cases. Thus, at page 17 (Resp. Br.) respondent cites *Green Bay & W. R. Co. v. Commissioner*, 147 F. 2d 585, 587 (C. C. A. 7th, 1945), a case where the Court had to decide whether debentures, the terms of which failed to provide for a fixed maturity date, and provided for non-cumulative dividends payable only in the discretion of the board of directors, constituted an indebtedness within the meaning of Section 23(b). No question was there involved as to the genuineness of the debenture instruments or as to the rights of the holders of those instruments to enforce the rights actually given

them under the terms thereof. The question was simply one of classification.

On the same page (Resp. Br. p. 17), respondent cites *Commissioner v. Schmoll Fils Associated,* 110 F. 2d 611 (C. C. A. 2d, 1940). That too, was a case where the genuineness of the instrument was not in question. The Court was simply concerned with the problem of whether or not the instrument, called a debenture, more nearly resembled preferred stock than an indebtedness in view of the provisions of the instrument itself. There the instrument provided that so-called interest should be paid exclusively from profits, that the debentures be subordinated to the rights of bank creditors and the instrument provided no maturity date at which the principal amount stated therein was to be paid. A similar type of case is *Commissioner v. Meridian & Thirteenth Realty Co.,* 132 F. 2d 182 (C. C. A. 7th, 1942), cited by respondent. (Resp. Br. p. 18.)

In the instant case, however, the instrument evidencing the indebtedness is a negotiable promissory note in ordinary form. If those notes are genuine, there cannot possibly be any problem of classification. True it is in this case that between April 1941 and November 1941, the indebtedness which existed was not evidenced by a promissory note and neither the rate of interest, the maturity date, nor other provisions of the terms of the loan had been determined. If interest paid pursuant to such loans were here involved, petitioner submits that in the absence of contract the law of the State of California would impose the omitted terms and the loan would be repayable upon demand, interest would be paid at the legal rate (Cal. Civil Code, Section 1914).* However, even if the

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*See Appendix.

loan, as it existed in this case between May and November, 1941, was deemed to be an obligation which, though genuine, was lacking in all the necessary ingredients of "indebtedness," the conversion of that obligation into promissory notes duly issued in November, 1941, would still require the conclusion that the obligations of the promissory notes were genuine indebtedness. See *John Kelly Co. v. Commissioner,* 326 U. S. 521, 90 L. Ed. 279 (1946); *Toledo Blade Company,* 11 T. C. No. 128 (1948), C. C. H. Dec. 16,736; *Cleveland Adolph Mayer Realty Corp.,* 6 T. C. 730 (1946), rev. in part on other grounds 160 F. 2d 1012 (C. C. A. 6th, 1947); *Clyde Bacon, Inc.,* 4 T. C. 1107 (1945), where in each case the obligation or instrument which was converted into an indebtedness was so converted in consideration of the cancellation of what was clearly and expressly a stock obligation.

It follows, therefore, that the single issue presented in the case can be answered only by determining whether the promissory notes issued by petitioner were genuine or were sham. In looking to the arguments raised by respondent, petitioner proposes to do so only to the extent that they tend to derogate from or support the genuiness of the promissory notes.

Respondent's first point seems to be that the promissory notes were issued to the creditors in direct proportion to their stock holdings. (Resp. Br. p. 15.) As a result, respondent points out that the stockholders are in a position at will to apportion monies paid to the company between stock and indebtedness. Moreover, respondent maintains that the ability to do this was in fact utilized because the plan finally adopted of the division between stock and notes was not in accordance with the original plan (Resp. Br. p. 16.) But respondent does not explain why the ability to change and the fact that pur-

suant to that ability the creditor-stockholders did change the ratio did support a conclusion that the change was not really a change and that the notes were not genuine. In *John Kelly Co. v. Commissioner, supra,* the stockholders converted to become stockholder-creditors and the genuineness of the debentures there issued were never questioned. That is also true of the *Cleveland Adolph Mayer* case, *supra,* and the *Clyde Bacon* case, *supra.* True, in the *Toledo Blade Company* case, *supra,* the Commissioner contended that the issuance of debentures in exchange for shares of stock was merely a sham transaction but the Tax Court gave short shrift to that contention merely by looking to the debentures themselves, undisturbed by the fact that there was a single stockholder, stating at page 2420 (C. C. H. Dec. 16,736) that:

> "Whatever may be said of the reasons underlying the transaction there can be no question but that the debentures themselves were genuine and evidenced legal obligations of the petitioner. Under their terms the debentures were absolute as to the payment of both principal and interest. Had they been issued to a non-proprietary purchaser for value there could have been no question as to their genuineness. The fact that they were issued to the petitioner's sole stockholder in exchange for a portion of the interest represented by its stockholdings in the petitioner does not affect their validity."

Respondent's next point seems to be the fact that because the entire $55,000.00 advanced was necessary to place the restaurant in condition to commence business, it was reasonable for the Court to conclude that the entire funds supplied by the incorporators were subject to the hazards of the business and part of its capital structure. (Resp. Br. p. 17.) Later, on page 20 of his brief, re-

spondent makes a similar point, quoting from *Commissioner v. Meridian & Thirteenth Realty Co.,* 132 F. 2d 182 (C. C. A. 7th, 1942), at page 186, to the effect that "the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation payable in any event." Respondent's error lies in his misconception of the nature of the risk involved. The risk which distinguishes stock from indebtedness and to which the *Meridian & Thirteenth Realty Co.* case referred relates to the different legal rights given to stockholders on the one hand and creditors on the other. Certainly stockholders do not have an obligation from their corporation which is payable in any event whereas creditors do have such an obligation from their debtors. The obligation to be repaid in any event did exist in favor of the creditors here and as the Court found [R. pp. 28-29], was one of the very reasons the creditor-stockholders chose to contract with petitioner in the manner in which they did. The only risk to which the amounts advanced to the corporation here as loans were subject were economic risks. In that sense, it is true that the entire amount was subject to the hazards of the business. This would have been true whether the monies were borrowed from the incorporators or from the bank. When monies are borrowed they are commingled with the borrower's other funds and normally are not set apart by the borrower as a trust fund. The borrower presumably uses the funds in his business and if the assets acquired with the borrower's own funds and the borrowed funds become consumed without replacement, a deficit is created and the borrower becomes insolvent. Almost every bankruptcy case is an illustration of how creditors' funds are placed at the risk of the business.

The case of *Maloney v. Spencer,* 49-1 U. S. T. C., ¶9176, Dec. Feb. 11, 1949 (C. A. 9th), is an excellent example of a case where a lender, who also happened to be the sole stockholder of two companies which became insolvent, found that the loans which he had made were placed at the risks of the business. If this fact tended to support a conclusion that a loan evidenced by a promissory note is not genuine, no loan which is unsecured can be said to be a genuine loan and that, of course, is obviously absurd. The case of *Green Bay & W. R. Co. v. Commissioner,* 147 F. 2d 585 (C. C. A. 7th, 1945), cited by respondent as support for his reasoning in this regard was the case in which the genuineness of the debenture bonds therein issued was not in question but the problem was one of classification. Because of other facts, as well as the fact that these debenture bonds were subordinated to other general creditors and were, therefore, placed at *greater* risk than ordinary loans, the Court concluded that the debentures were more akin to capital stock than to indebtedness. If the promissory notes here involved had been placed at greater risk than the obligations to general creditors, that factor might have weight to support a conclusion that they were not genuine, although even such a subsordination was considered compatible with genuine indebtedness in *Commissioner v. O. P. P. Holding Corp.,* 76 F. 2d 11 (C. C. A. 2d, 1935). However, in this case there was no desire to have these notes placed at greater risk than the obligations owing other creditors. On the contrary, the Court expressly found that "the individuals desired to be in a position to participate with general creditors for part of their investment in the event petitioner's business was not successful." [R. p. 28.]

Respondent next points out that no interest was ever paid or accrued between May and November, 1941, as well

as the fact that the maturity date, rate of interest and the amount of the indebtedness were not fixed as the advances were made. Petitioner has amply discussed these points in its opening brief (pp. 29-37) and mentions the point here merely for the purpose of continuity.

In the next paragraph of his brief (p. 17), respondent, in one breath and one paragraph seems to be making several points. In his first sentence he discusses the scope of review. This matter has been amply covered by petitioner in its opening brief (pp. 43-47). He next makes the point that "apart from the testimony of the incorporators to the effect that they intended that part of their investment to be taken in the form of loans, and the fact that 'promissory notes' were issued, there is little in the record to support the contention that a bona fide creditor relationship existed." Petitioner is at a loss to understand what more respondent requires in the way of evidence. There were, after all, only a limited number of advances and notes. In effect, respondent asserts that the Tax Court was justified in asserting that the petitioner's incorporators were perjuring themselves simply because they did nothing more than testify as to their intent [R. pp. 65-66, 138] produce the notes [Pet. Ex. 19, 20, 21] produce the minutes of the corporation [Pet. Ex. 12], produce the application for the issuance of a stock permit dated July 14, 1941 [Ex. 4-D, R. p. 298] wherein they announced, under oath, their intention to have the corporation borrow money from the incorporators and adduced the testimony of their attorney. [R. pp. 250-251.]

The next point made by respondent (Resp. Br. p. 17) and in the same paragraph, is the fact that originally the taxpayer's books did not reflect any promissory notes

or indebtedness to the taxpayer's incorporators. Petitioner has amply covered this subject in its opening brief. (Pet. Br. pp. 39-42.)

Respondent makes a similar point (Resp. Br. p. 18) with respect to the balance sheet included in the income tax return for the year 1941. While it is true that this return was signed by petitioner's president, it is also true, as respondent's witness, Whittaker, testified [R. p. 110] that petitioner's president did not read the return. Since the question of the incorporators' intent relates to their state of mind, the failure to show the indebtedness upon the balance sheet contained in the return cannot be said to be inconsistent with Carpenter's state of mind where Carpenter was actually ignorant of this failure.

Respondent's next new point (Resp. Br. p. 19) relates to the requirement of a maturity date for an indebtedness. Petitioner concedes that an essential attribute of a creditor's obligation is a fixed or determinable date for the payment of the obligation. But in this case, if the notes were genuine, there was a fixed maturity date fixed at two years from the date of the note. Petitioner submits that the test of genuineness is not the date of actual payment. A creditor might in advance intimate his intent to be fair or lenient under proper circumstances but that alone would have no bearing upon his rights. The nature of the obligation is determined by what its holder has a right to do and not what he may choose to do under given circumstances.

Respondent's next point concerns the creditor's so-called laxity in enforcing their rights and protecting their investment. (Resp. Br. p. 19.) From this alleged laxity, respondent draws the conclusion that it was never intended

to assert the right to demand from the corporation a fixed amount on a fixed date in payment of the obligation but rather that it was intended to recover this portion of the capital investment when and if the fortunes of the business warranted. It is easy to submit that this is "the only reasonable conclusion" because to a large extent reasonableness is a matter of opinion. Actually in this case, we find and the Court held [R. pp. 28 and 29] that the incorporators wished to be in a position to demand payment of their loans after a limited period even if the corporation did not have a profit. Therefore, at the outset, they were concerned with their *right* to demand repayment and in November of 1941 fixed the two year period as maturity date. It is far more reasonable to assume that at the end of the two years they acted in the light of the facts as they existed at that time rather than to assume that at the outset they did not intend to have the *right* to demand payment at the maturity date. Respondent speaks as if banks never renew instruments after maturity; yet if petitioner here had issued renewal notes at the end of the two years, it is reasonable to suggest, in view of the tenor of respondent's brief, that respondent would have dismissed this act as a mere formalistic gesture. Actually, since the notes were far from outlawed at the time they were ultimately repaid, the holders' acts in failing to demand renewal notes from the corporation which they controlled does not reflect their intent at the time they made the advances or at the time of the issuance of the notes.

Nor does the fact that the incorporators hoped and expected that there would be profits in the business detract from their intention to make loans. In the recent case of *Maloney v. Spencer,* 49-1 U. S. T. C. 9176, decided Feb. 11, 1949 (C. A. 9th) the taxpayer caused to be incorporated three corporations, in which he owned all of the stock other than the qualifying shares. The taxpayer paid no cash for his stock but transferred contracts to the companies in exchange for the stock. Although he attempted to obtain outside loans for the financing of the corporation's activities, these attempts were unsuccessful and as a result he was required to advance considerable sums to his corporations continuous over a period of three years. The opinion in the case does not reveal any demands by the taxpayer upon the corporation for repayment of these advances. In holding that the advances constituted loans and not capital contributions, the Court pointed out that

> "the liabilities were agreed to be incurred by taxpayer in the expectancy that the corporations would be successful in business and pay off the obligations to him. . . ."

There, in spite of the fact that the taxpayer did not make demands or sue his corporations for recovery of the amounts advanced, the Court did not think that the only reasonable conclusion to be drawn from the taxpayer's failure to do so was that it was never intended by the taxpayer to assert the right to demand repayment of the fixed amounts at a fixed time. Nor did the Court think it fatal that the creditor stockholder there hoped and expected that

the corporations would make substantial profits and thereby be enabled to repay the advances.

On page 21 of his brief, respondent suggests that "apparently it is taxpayer's position that the holders of the 'notes' may treat themselves as creditors for taxation purposes but conduct themselves as stockholders in regard to the alleged 'loan'." Obviously that is not petitioner's position. Petitioner simply maintains that incorporators have a right, if they choose, to lend money to their corporation, even though in direct proportion to their stock holdings. That a tax advantage from such a situation may result does not derogate from that right any more than the fact that other legal advantages may result. Some of such other legal advantages were the right to share with other general creditors in the event of failure mentioned by the Court [R. pp. 28-29], the right to receive repayment of the loans unrestricted by California Corporation Code, Section 824* or the right of any given minority stockholder to receive repayment unrestricted by the will of his majority co-stockholders. It is petitioner's position that when a Court views the subsequent actions of such a creditor stockholder for the purpose of determining what went on in his mind at a prior date, the Court cannot properly weigh those actions for that purpose if it disregards the fact that the creditor who also has a proprietary interest will fail to be on the court house steps with a Writ of Attachment on the day following maturity.

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*See Appendix.

In summary, respondent's brief does nothing to strengthen the weaknesses in the Tax Court's opinion which petitioner has heretofore discussed in its opening brief. The conclusion of the Tax Court still remains erroneous and its decision should therefore be reversed and judgment entered in favor of the petitioner.

Respectfully submitted,

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APPENDIX.

Civil Code of California, Sec. 1914. Interest on Loan. Whenever a loan of money is made, it is presumed to be made upon interest, unless it is otherwise expressly stipulated at the time in writing.

California Corporations Code, Sec. 824. Unlawful Purchase of Shares, Declaration of Payment of Dividends, or Withdrawal or Distribution of Assets. Except as provided in this division, the directors of a corporation shall not authorize or ratify the purchase by it of its shares, or declare or pay dividends, or authorize or ratify the withdrawal or distribution of any part of its assets among its shareholders.